Remarks of

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Introduction.

Thank you all for that warm welcome. Miami in late November is not a bad posting – and I appreciate your decision not to hold this Forum in Buffalo. In all seriousness, I am pleased to have the opportunity to speak before you today. AITAL is an important organization that has done much to promote dialogue on issues of importance to the aviation community in the Americas, and I appreciate the invitation to be with such a distinguished audience today.

I see on the program that I am slated to speak on "Washington Trends." When I mentioned this to a friend of mine who happens to work in the fashion industry in Miami, she proceeded – once she stopped laughing – to crack jokes about "color coordinated pocket protectors." While I will confess that Washington may not be the trendiest town, it is an enormously interesting and exciting place to be right now – in the period between the election and the start of President Bush's second term.

At the Department of Transportation, there is a palpable sense of excitement as we review our priorities, anticipate challenges, and seek to define our agenda for the next four years. Working with the White House, State Department, and other agencies, my staff and I are doing that with specific reference to aviation.

Let me share a few very fundamental beliefs that inform our thinking as we approach that task:

- First, there is a clear appreciation and understanding that efficient, safe, and secure aviation is critical to the achievement of broader domestic, regional, and global economic and political objectives. In short, aviation is important because it is a facilitator of domestic and international economic growth and of mobility, freedom and democracy. The policies we adopt must recognize its importance and enable it to fulfill those functions.

- Second, stated simply: we have a strong predisposition to market-based solutions where possible. We recognize that in certain cases and with certain issues – and I will touch more on these cases later – there may be a continuing role that government has to play. But, it is our view that, over the course of history, with certain rare exceptions, government has been an impediment to the effective functioning of the aviation system, not the solution.

- Third, there is a clear recognition that aviation must – more than ever before – be viewed in a global context. Lest there was any doubt, it is now clear that the airline industry is an international network – or, rather, an international network of networks. While – in a world of sovereign states – such networks cannot (and should not) work entirely free of national governmental control, those constraints should be minimized where possible.

- Finally, our aviation policymaking must be informed by the current state of the airline industry, both domestically and abroad. And I would like to spend a bit of time on this subject this afternoon, because I would submit that it is this topic – the state of the airline industry – that most immediately affects the Department's aviation outlook and agenda, both domestically and internationally.

<u>The Current State of the Airline Industry</u>.

So let me turn then to discuss what we, in Washington, believe is going on in the airline industry – domestically in the United States and internationally – and why what we see going on is happening.

It is probably news to no one here that the U.S. airline industry is in the midst of a fundamental restructuring. Earlier this year, Secretary Mineta observed that there is a "paradigm shift" underway in the industry. The current financial state of the industry – with two major passenger carriers in bankruptcy and the others all actively reorganizing to avoid it – is evidence that this is an industry in a fundamental process of redefinition.

In the United States, the shift reflects, I believe, the ongoing evolution of a deregulated industry. The mixed picture of the industry that we see today – with certain subsectors (most notably, certain of the so-called legacy carriers) facing serious challenges while others (most notably, the low cost carriers, but also many of the regional, cargo, and express carriers) are doing quite well – both underscores and offers some insight into the structural nature of the changes underway.

The first insight is that the financial challenges currently facing our legacy carriers have been in the making for quite some time. The combination of spiraling costs that began in the 1990s and the rise of a new generation of stronger, better-capitalized low-fare airlines have contributed to the cost pressures currently confronting many of our legacy carriers. Adding to the pressures has been the increased price transparency faced by all airlines as a result of growing airline Internet ticket sales.

For years, our large network carriers were able to transcend cost-side pressures with revenue-focused strategies – largely centered on the high-yield business traveler. With innovations like sophisticated global distribution systems, revenue management, and frequent flyer programs, airlines were able to segment demand and achieve yields capable of covering relatively high costs. The strategy generally worked because the business traveler grew accustomed to paying high fares and didn't have any really attractive alternatives, and because the airlines enjoyed a greater ability to control the number of seats available to discretionary travelers. Those conditions appear to exist no longer. Yields have declined substantially since 1999 and – notwithstanding the broader economic rebound – remain low. Business travelers are increasingly turning to the growing variety of attractive low-fare options available (including options offered by the legacy carriers themselves) and the expansion of LCCs has diminished the legacy carriers' ability to control attributable to control supply.

It can all be summed up as follows: Throughout the first quarter-century of deregulation in the United States, the market for scheduled passenger air transportation was driven by the constraints and confines of its providers. That supply-driven characteristic of demand is coming to an end. Demand now is beginning to drive supply.

As the executives of a number of U.S. legacy carriers have recently said, they no longer have any choice. To be able to serve the huge pool of price-sensitive travelers profitably, their costs must come down. Whether the U.S. legacy carriers are going to remain an industry force will, accordingly, depend in large part on how successful they are in achieving lower costs. They are leaving no stone unturned in that cause. While most legacy carriers have already achieved cost reductions that border on the heroic, recent developments suggest that still more will be needed.

<u>International Effects of the Paradigm Shift</u>

While this restructuring process is going on – indeed, as <u>part</u> of the restructuring process – we see the U.S. airlines again beginning to look outward. We have recently seen U.S. legacy carriers announce plans to start new international services to points in Europe and Asia. US Airways, Continental, and Delta have all either started or indicated an interest in growing their international services in the Latin American region. They are doing this both with their own aircraft and in combination with code share partners. And it is not just the U.S. majors that are doing this. We have seen LCCs enter – admittedly in a limited form, but entry nonetheless – international markets. Today, JetBlue, Spirit, Airtran, ATA and Frontier serve points in Mexico and the Caribbean.

The common explanation for this is that the U.S. carriers are entering markets where yields remain high. To be sure, that is part of the explanation. But I think it is only part. The reality is that, with new, lower cost structures and an increasingly transparent <u>international</u> market for air transportation, U.S. carriers are increasingly better able to compete globally than they have been in years past. And our expectation is that their entry or reentry into these markets will stimulate traffic that heretofore has not been able to afford to travel abroad.

From an international perspective, what is fascinating is that the paradigm shift we see occurring in the United States also appears to be happening in other parts of the world – even in places that have historically been perceived as far more "regulated" than the U.S.

In Europe and Asia, rapidly changing, dynamic marketplaces, with robust demand for air travel, legacy passenger network carriers are being challenged by LCCs like Ryanair, EasyJet, and Air Asia. Legacy carriers around the world are responding in similar ways. Some, like America West and Aer Lingus, have transformed themselves into low-cost carriers. Others, like United, SAS, and Qantas have formed low-fare airline brands. Yet others, such as Lufthansa with Germanwings and Singapore Airlines with Tiger Airways, are investing in independent low-fare carriers. All, however, are focusing on costs to an extent heretofore unknown.

Latin America may have arrived a bit later to this trend, but I would submit that it will affect air transportation here no less than any other region of the world. We have been watching with interest Brazil's low-cost carrier, Gol, which in 2003 saw a fivefold increase in earnings compared to 2002 and achieved an operating margin of 24.4 percent – second only to Ryanair in Europe. During a year in which Brazil's domestic industry actually contracted 6.2 percent (in RPKs), Gol's traffic jumped 53 percent. Due to fares typically 20 to 30 percent lower than its competitors and more seats available at those fares, first-time fliers account for 5 to 10 percent of Gol's passengers, showing the huge growth potential, even for countries with populations having lower disposable incomes. And I would suspect that Gol is only the first of other LCCs to come in the region.

In short, I would submit that the paradigm shift we currently see ongoing in the global airline industry is <u>inexorable</u>. And it is inexorable because it is being compelled by the marketplace – by the enormous untapped demand for transportation worldwide.

The principal beneficiaries of this dynamic, highly competitive market place are, of course, the consumers – both in the United States and abroad – who have available to them more transportation options at lower prices. But the benefits go beyond consumers. They encompass the entire economy – the small businessman who can now afford to conduct the client meeting; the university able to attract the student from a distant point; the city whose restaurants, hotels, and businesses are supported by the traffic generated by LCCs. Increasingly – and this goes back to one of the core principles I mentioned above – air transportation is being seen by policymakers at home and abroad not just as an end unto itself, but as a generator of economic growth.

<u>The Impact on Policymakers and Policy</u>

What does all this mean for policymakers? Policymakers – and here, I mean policymakers both in Washington and in capitals around the world – have two choices: to seek to stand in the way of this onrushing tide or to harness its power and ride the wave. Increasingly you see policymakers choosing the second option. Increasingly we are seeing governments – in countries ranging from Ireland to Thailand, from India to Malaysia – realize the enormous broader economic and political benefits to be derived from allowing the paradigmatic change to happen.

Moreover, you see those who originally sought to resist the change by putting up barriers – refusing, for example, to allow new carriers to challenge the incumbents – changing tack. Whatever the viability of that strategy thirty years ago, I believe it is simply no longer viable in today's globalized economy. Other economic pressures – the pressures to attract business – have made the protected airline industry an unaffordable luxury. A country's refusal to liberalize – and with it, the effective imposition of higher fares on passengers, and the consequent deterrence of air travel – is simply no longer affordable in today's economy where capital will move seamlessly from where artificial barriers to entry (such as unnaturally high air fares) exist to where they do not.

So let me turn finally to what roles we do see for government in this period of enormous change. I would suggest that those roles are severalfold:

First, government will and must continue to be involved in ensuring the safety and security of air transportation. The role played by aviation safety organizations, such as the FAA, and aviation security organizations, such as the TSA, are critically important to the vitality of our industry. I should note in this regard that the U.S. is actively committed to improving aviations safety and security, not just in the United States, but internationally as well. In Latin America, for example, the Department has recently concluded a bilateral aviation safety agreement with Brazil, has been working very closely with Mexico to improve air navigation and aviation safety, and has provided in-country training and technical assistance this year to Panama, Argentina, Ecuador, Colombia, and several countries in the Caribbean.

Second, there will be certain "public goods" necessary to the efficient function of the aviation system that government must continue to supply. The global aviation infrastructure – runways, airports, ATC – comes to mind. Now, I am not sure quite where the boundary is between what government must do here – which public goods would not be supplied by the private sector, if government were unwilling to act – and what areas are capable of being sustained by the private sector, and certainly this is an area ripe for some thinking. But, I think it is beyond debate that government will and should continue to remain involved in this area to ensure that aviation fulfills its broader societal contributions.

Third, government must seek to permit carriers to compete as freely as possible – to minimize the regulatory burden on them, and where such burden is necessary, to apply the burden as evenhandedly as possible.

Internationally, this involves working bilaterally with our likeminded partners to open currently restricted markets. Let me note a couple of specific areas that may be of interest to you all. In Latin America, we were delighted to conclude an Open Skies agreement with Uruguay last month, bringing our total number of Open Skies partners in the region to 14. And just last week, Secretary Mineta and his Mexican counterpart Secretary Cerisola agreed to launch negotiations in early December with the goal of expanding opportunities for carriers in the enormously significant, cross-border market.

Elsewhere, we recently concluded an air services agreement with China that will more than double the number of U.S. carriers that can operate in the market and increase the number of frequencies by fivefold. We believe that this landmark agreement will reshape U.S.-East Asian aviation relations. And, we continue our discussions with the European Union, with the goal of a complete bilateral opening of the transatlantic markets with all 25 EU member states.

Domestically, minimizing the regulatory burden involves reducing the constraints on carriers to structure their operations (domestic and international) in the ways they believe best. Let me single out three areas in specific:

- *Operation of alliances/code sharing*. In a world where bilateral and legal limitations on carrier ownership remain, code sharing alliances have been resorted to by many carriers seeking to capture efficiencies of scale and scope. It remains the Department's view that alliances and code sharing generally benefit carriers and consumers, and it is generally our policy (absent some other compelling reason) to approve code shares. In this regard, let me point out to you an order to show cause that we recently issued proposing to allow a carrier alliance – in this case, the TACA group – to collectively utilize a common trade name (TACA) and to use a common designator code (TA) to sell all of its flights. While a final decision has not been issued and I accordingly cannot discuss the merits of the case, I can tell you that our tentative decision concluded that there are public benefits that will be realized from the implementation of a proposed common name, and that, subject to certain conditions being met, there is no reason for the government to preclude the carriers from enhancing their alliance as they see fit.

- *CRS systems*. At the end of last year, the Department terminated decades of regulation of Computer Regulation Systems. Finding that the basis for the CRS regulations no longer existed, the Department has freed airlines and CRS systems to enter into arrangements as they see fit. We will continue to be vigilant in looking to ensure that government regulation does not needlessly hamper airlines or distribution companies as they seek to explore creative means of marketing their services.

- *Equity structures*. Finally, the Department continues to consider how most effectively to ensure that airlines' need for capital is not stymied by laws prescribing ownership. We in the Bush Administration advanced a proposal last year to increase foreign investment up to 49 percent – a proposal never acted upon by Congress. Certain prominent figures in U.S. industry have recently argued that the U.S. law needs to be amended to further liberalize in the area of ownership – even to permit foreign citizens and carriers a right of establishment. Clearly, this is one area that requires careful consideration in the weeks and months to come. I would note that the examples of a number of Latin carriers, including both the TACA and LAN groups, of forming cross-border equity alliances provides an interesting example for us to consider in this area.

Conclusion

Let me conclude by returning to where I began – the feeling of excitement shared by many in Washington, as we embark on policymaking for the next four years. In the area of aviation, that excitement is only enhanced by the substantial changes underway in this most dynamic industry. For some in the industry – including, I would conjuncture, some in this room – that feeling of excitement may be tempered by a sense of concern over the changes afoot. Certainly, that is understandable. Change as fundamental as that which is ongoing isn't easy, and does cause dislocations.

But I would offer three points to those who are uncertain: First, this industry has shown itself to be remarkably resilient over the past 25 years and is blessed by some of the most gifted and creative business minds in industry. If any group can adapt and thrive in this changing world, I would submit it is this group. Second, the future to which we are headed is a better one – for our economies, for consumers, and for many carriers, who will emerge stronger and more stable. Finally, like it or not, change is inevitable. It will occur. The choice we all have, as I noted before, is to ride the wave or wait and have it crash over you. As for me, I'm going to get my surfboard. Thank you.